

PRELIMINARY REPORT

PRICE STRUCTURE COMMITTEE

SUBMITTED TO

AGRICULTURAL MARKETING SERVICE
DAIRY DIVISION

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PREFACE

The Federal Agriculture Improvement and Reform Act of 1996 (1996 Act) became law on April 4, 1996. The legislation gives the United States Department of Agriculture three years to consolidate the existing Federal milk marketing order system into no more than fourteen marketing areas and no fewer than ten marketing areas.

The Agricultural Marketing Service, through Dairy Division, embarked immediately on the task assigned by the 1996 Act. The Director of the Dairy Division appointed a committee to review and make recommendations for a price structure in the consolidated system. The committee was to work closely with other committees assigned tasks in other sectors of the consolidation process.

Specifically, the Price Structure Committee was to develop a pricing structure to be used in the Federal orders and to develop the corresponding order language.

PROCEDURE

In early May 1996, the Director of AMS, Dairy Division, set in motion procedures to focus the direction of the implementation of the provisions of the 1996 Act. First, a memorandum was distributed to all interested parties with the stated purpose of announcing procedures to implement the 1996 Act and its mandates to the Federal milk order program (Appendix A). The memo outlined the authority for informal rulemaking contained in the 1996 Act and pointed out its difference from the formal rulemaking procedure that has been historically used. The message to the dairy industry in the memo was direct and clearly indicated the desire for industry input.

The announcement went on to give a time line for the total implementation of the requirement of the 1996 legislation. This time sequence again emphasized that industry was being afforded the opportunity to fully participate. Shortly after the notice to the public, this committee (along with three others) was appointed.

REVIEW

Federal milk orders are authorized under the Agricultural Marketing Agreement Act of 1937 (1937 Act). The 1937 Act is the basis for the classified pricing system that Federal milk orders embrace. It established the "supply/demand" standard that has been used throughout the ensuing 59 years. It gave the Secretary of Agriculture the ability to use his expertise through the formal rulemaking process. The notable exception was the amendment contained in the 1985 Food Security Act (1985 Act) mandating Class I differentials for a period of two years at certain geographic locations within the country.

Using the expertise available to the Secretary, the dairy industry has submitted, justified and approved individual Federal milk marketing orders covering at one time more than 80 distinct areas. The same procedure has also allowed this system to merge smaller areas into larger markets and thereby reduce the number of markets to a total of 33, the number when the 1996 Act was signed into law.

The 1937 Act requires a price structure to generate an adequate supply of milk for the fluid market. This has been accomplished in recent history using a basic formula price as the measure of supply/demand to move milk prices up or down. The Minnesota-Wisconsin price series and the current Basic Formula Price (BFP) have been the vehicles to accomplish this objective.

Differential pricing for Class I above the basic formula level has been used mostly as the means to capture the extra value commanded by Class I milk, and, consistent with the 1937 Act, to establish location value for raw milk.

SUPPLY/DEMAND

The supply/demand standard is used for pricing milk in the Federal milk order system. As stated in instructions to the committee, the recommendation must insure that adequate supplies of milk can be obtained for fluid use in accordance with the Agricultural Marketing Agreement Act of 1937.

The following table provides summary data on milk production and population. It gives some reference to milk supply and consumption within certain broad regions of the country. The data are for calendar years 1984 (the year prior to the passage of the 1985 Act) and 1995 (the year prior to the passage of the 1996 Act).

This summary table has been compiled as a general reference tool for use when reviewing large amounts of detailed information compiled by Cornell University. A Cornell University, Agricultural Economics Staff Paper 96-06, contains more detail on supply, processing and consumption centers of the United States.¹

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Pratt, James, Andrew Novakovic, Mark Stephenson, Phil Bishop, Eric Erba, U.S. Dairy Sector Simulator: A Spatially Disaggregated Model of the U.S. Dairy Industry, Staff Paper 96-06, Cornell University, Agricultural Economics, November, 1996.

TOTAL MILK PRODUCTION AND RESIDENT POPULATION REGIONS FOR CALENDAR YEARS 1984 AND 1995									
	NORTHEAST			SOUTHEAST			SOUTHWEST		
	MILK PROD.	POP.	PROD. PER CAPITA	MILK PROD.	POP.	PROD. PER CAP.	MILK PROD.	POP.	PROD. PER CAPITA
	(Billion Lbs.)	(Million)	(Lbs.)	(Billion Lbs.)	(Million)	(Lbs.)	(Billion Lbs.)	(Million)	(Lbs.)
1984	39.85	79.94	498	15.04	55.51	271	8.15	26.95	303
1995	40.94	83.73	489	14.55	63.57	229	14.82	31.62	469

	MIDWEST			WEST			TOTAL		
	MILK PROD.	POP.	PROD. PER CAPITA	MILK PROD.	POP.	PROD. PER CAP.	MILK PROD.	POP.	PROD. PER CAPITA
	(Billion Lbs.)	(Million)	(Lbs.)	(Billion Lbs.)	(Million)	(Lbs.)	(Billion Lbs.)	(Million)	(Lbs.)
1984	48.19	33.53	1437	24.04	37.72	637	135.28	233.65	579
1995	46.36	35.30	1313	38.81	46.16	841	155.48	260.38	597

NOTE: (1) See Appendix B for regions.
(2) Total milk production (not farm marketings) as estimated by National Agricultural Statistics Service.
(3) Population estimates from U.S. Bureau of Census.

PUBLIC INPUT

The impetus for fulfilling the requirements of the 1996 Act includes the full consideration of dairy industry positions. The Department has long recognized the expertise that exists in all segments of the dairy industry.

To date, the Department has received about 150 comments from many segments of the dairy industry and other interested parties. Of the correspondence received regarding price structure, some proposals can be classified as regional, while others are national in scope. Nearly all proposals were presented in a conceptual format, rather than being fully developed, and some presented one or more alternative approaches. Appendix C provides summaries of public input comments addressing price structure. The committee has grouped the comments into general categories for purposes of this report. There is obviously overlap within the comments as they relate to several issues other than Class I price. However, they may be grouped in a general way to address the price issue.

Basic Formula Price Plus Differentials

The committee reviewed the proposals received to date and found overwhelming support for some kind of "differential" or classified pricing structure to capture the extra value commanded for milk for fluid use. The committee found considerable support for continuing a BFP with a Class I price differential. Many proposals recommended that the committee consider multiple basing points. The committee has undertaken some detailed analysis of

BFP plus a differential for Class I milk. It follows under the heading of "Current Work" in this report.

The Federal order system has adopted classified pricing as a tool to value milk and milk products. Milk as an input has multiple uses to the consumption side through varying product demands. Orders historically have defined Class I as having value above other uses. It is not our purpose here to delve into the classification system, but to begin at that point. To do this, some system to "differentiate" the value of fluid milk use is necessary. As long as a system of classified pricing is in use, a differential is involved. While the term "differential" may be used generally in other analysis, in terms of this discussion of BFP plus a Class I differential it is being used to incorporate the value of Class I milk above the basic price level of milk used for manufacturing.

Timing of Price Announcements

Some proposals generally supported the current system, but suggested that some or all class prices be announced for a period longer than the current monthly basis. Most suggested that the period be quarterly. Others suggested alternate methods of determining the BFP. (Determination of the BFP is the responsibility of another committee and will not be directly addressed by this committee.)

The committee has reviewed these suggestions dealing with the timing of price announcements and perhaps the period of time for a price. Class I and Class II prices are

currently announced on or before the 5th of the month for the following month and are based on the previous month's BFP. Class III and III-A prices and the butterfat differential and butterfat, protein and other component prices, where applicable, are announced for the preceding month on or before the 5th of the month.

There are a number of issues involved in the timing of price releases. Processors of Class I and II products seek advance notice of prices to make any necessary adjustments forward to their customers. Price volatility is a factor often cited as a reason to review the timing of price announcements. In addition, processors often struggle with the allocation of the cost of butterfat within their operation.

While it could perhaps be uniformly agreed that prices should be timely, responsive and minimally intrusive, in the regulated market some balance is necessary. A basic question which is involved in timing of prices is: "How much time is tolerable in sending the proper signal through the system?" Our current system for Class I and II delays the signal to the production side already. It is a bit of a trade-off to the consumption side to give time for adjustments.

A second question deals with how long a delay is acceptable if prices are announced for a longer period. For example, in a particularly volatile time period, do price adjustments accumulate disproportionately against price projections? Additionally, are ingredient costs comparable in Class II over extended time periods?

The timing of the announcement of the butterfat differential is also a subject for review. The valuing of butterfat in the Federal order system has been left to individual entities to allocate in their business. Orders do not price the differential value of butterfat on a classified basis.

Processors, particularly fluid processors, often seek to assign the "cost" of excess fat to their fluid side. The handling of this excess fat is a daily occurrence in the fluid side. The question is: "Does an advance estimate of the value of the fat serve the market better than allowing each processor the freedom to handle its costs internally?"

The committee has the timing of price announcements on its agenda. However, at this time, the committee believes that the issues involving basic formula, class price surfaces, price level and pricing formulas need to be finalized before any discussion on timing is addressed.

Two-Tiered Class I Differential

Proposals, however, were not limited to the current BFP plus differential structure. Several comments were written in support of what was defined as a two-tiered Class I differential.

Specifically, industry proposed one concept that was determined to meet the criteria of a two-tiered Class I differential. The concept was presented in a number of submissions. The proposals were modified in late October, 1996.

Original Proposal

As originally proposed, Class I differentials would be set in each order as the sum of three parts as follows:

1. A flat \$1.00 per cwt., or another specified amount, that would represent the additional cost of maintaining Grade A milk supplies. This part of the differential would be the same in all orders.
2. A per cwt. value to fund a transportation credit for milk supplied to pool distributing plants, either direct from farms or shipped from other plants. It appears that although the transportation credit rate might be the same in all orders, the impact on the Class I differential to pay for it would likely vary across orders.
3. A per cwt. value to fund a balancing credit paid to supply organizations for maintaining milk supplies to balance the Class I market. Like the transportation credit, the impact of this balancing payment fund on the Class I differential would likely vary across orders.

Differences in Class I differentials among orders would be due only to differences in the money required to fund the transportation credits and balancing payments (parts two and three outlined above). In addition, the Class I differentials would likely vary across time as the dollars to fund the transportation and balancing payments would vary from year to year. This could be exacerbated by pooling structure, particularly an open pooling concept submitted as an integral part of this pricing proposal.²

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Pooling structure has an influence on this pricing system. However, this committee has not been assigned responsibility for analyzing pool structure at this time, but notes that it is contained within the proposal.

Modified Proposal

The modified proposal substantially changes the three-part differential outlined above.

According to the proponents of this idea:

This concept would establish a fluid supply area for each market from which milk production around the major bottler locations is procured and a reserve supply area outside the fluid supply area from which milk production generally is not supplying fluid handlers in the major fluid bottling locations...The Class I differential for the reserve area would be \$1.00 per cwt. and for the fluid areas it would be \$1.00 plus the distance from the reserve area to the fluid demand area (generally metropolitan areas) times \$.028 per 10 miles (approximately 80 percent of actual transportation costs). Fluid handlers in the fluid supply area would pay the higher differential and transportation credits and balancing credits (as the Coalition proposes their use) would be drawn from the market order pool.

In their modified proposal, the proponents suggest a two-part Class I differential. All distributing plants would be subject to a \$1.00 per cwt. differential, plus those in individually designated "fluid supply areas" would have an additional differential added to the \$1.00. These transportation credits and balancing payments would be provided to organizations which supply the order's fluid market and would be funded out of the pool.

No numerical analysis was provided on the expected impact of the proposals on the various regions of the country, however, it is the committee's understanding that some analysis is

currently underway. The proposals were presented as concepts, with little detail on application. A number of fundamental questions remain unanswered:

1. Would the transportation and balancing credits proposed be adequate to encourage milk movements to fluid processors on a regular basis?
2. How would overlapping fluid supply areas be handled, especially in markets that may be fluid deficit during certain periods?
3. With open pooling, what mechanism would be in place to assure that every market would have adequate milk supplies for Class I purposes? In other words, what would happen if no handler elected to pool milk in an order?
4. What would the impact of such a proposal be on supply plant and Class I handlers in different regions?
5. What would be the impact of this proposal on producers in different regions?
6. Does this proposal meet the requirements of the 1937 Agricultural Marketing Agreement Act?

The proponents of this concept indicate they will be working with Cornell University researchers to provide price structure for this proposal and that analysis of the Cornell results will be provided at a later date. The late-October revision to the proposal represents a substantial revision to the concepts submitted earlier. The committee has had limited time to analyze the modified proposal, but will continue to evaluate this proposal in the future and as the Cornell results become available.

Pooling Differentials Only

Several comments were written in support of eliminating all manufacturing milk classes, and pooling of Class I differentials only. Proponents of these proposals suggest all processors and manufacturers would compete for available milk supplies providing producers with a basic competitive price for their milk. Questions arise as to whether this approach meets the requirements of the 1937 Act of pricing milk based on form and use. The committee is currently pursuing this question before conducting any further analysis.

Decoupling Class I Prices from Class III Prices

Public input has provided several proposals for "decoupling" Class I prices from Class III prices. While the term "decoupled" has been construed in a number of ways, a review of the proposals to date indicates that there is some concern about the BFP and how it influences Class I prices. What is unclear is whether proponents' concerns about the effectiveness of the current BFP are influencing their proposal to decouple or if, in fact, they are suggesting that Class I prices remain completely independent of Class III prices. The purist definition of decoupling is to determine Class I prices without tying them to the Class III price through differentials. This approach implies no relationship between the value of milk for fluid use and milk used for manufacturing. With this in mind, in general, decoupled prices could be determined in two ways:

1. Set Class I prices administratively. An individual, or a group, could determine Class I prices based on data deemed appropriate at the time. Economic

indicators, market conditions, and other factors could be used to set the price.

Prices set administratively beg the traditional journalistic questions: Who? What?

When? Where? Why? and How?

2. Set Class I prices on a relationship based on something other than the Class III price. Several possibilities are available under this method, ranging from a fixed price to a price based on an economic formula. Fixed prices could be adjusted periodically based on changes in cost of production, Class I utilization, or dollars required to fund a transportation pool. An economic formula could include such factors as commodity prices, cost of production or feed prices, fuel costs, CPI, inflation rates, labor rates, per capita disposable income, etc.

Setting Class I prices based on something other than the Class III price, however, raises many questions: What are appropriate factors to include in a fixed price or economic formula mover? What is the appropriate Class I base price? Does the formula meet and maintain the supply/demand standard? Does it sustain the adequate supply for fluid use mandate? What adjustments or snubbers may be necessary to maintain an appropriate relationship to the Class III price? Should a differential structure be applied to the Class I price? At what level and when?

Additionally, an economic formula raises issues of performance over time. Limited use of economic formulas has met with little success over the long term. Attempts to equate milk

prices within the larger market often struggle with changes in technology and economies of scale within the industry.

While it is true that milk for fluid use and milk for manufacturing use have different values, the realities of the characteristics of milk supply and demand, and the 1937 Act mandate "to provide an adequate supply of milk" for fluid use suggest the necessity of a relationship between the price of milk for fluid use and milk used for manufacturing. This could be done in different ways under decoupling. One is to introduce a snubber to maintain the added value of milk for fluid use. Another is to provide for an administrative review of price relationships when conditions warrant.

California System

Several proponents suggested the use of the "California system" for setting Class I prices. The California system is best described as a partially decoupled system in the context of this discussion. Importantly, the system provides for expedited hearings when conditions warrant.³

The "California system" may have merit because it maintains a relationship between milk for fluid use and milk for manufacturing use. Additionally, prices are determined using commodity reference prices as an indicator of supply and demand.

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Boynton, Robert D, Craig Alexander (ed.), Milk Marketing in California, Dairy Institute of California, May, 1996.

To adopt the system nationwide, several questions would have to be answered. Would the California pricing system provide appropriate price levels? Would the national system be component based? Should class prices be adjusted spatially to reflect regional movement of milk and/or dairy products? Should commodity prices rather than competitive prices be used as a price mover? How would the existence of California fluid milk component standards affect price levels? What criteria would be used to establish base prices? How does the end of the support price affect the pricing? How would a make allowance be established? Would an expedited hearing process be necessary to respond when disorderly market conditions exist? Who would be the decision makers in such a process? Should a differential structure be applied to the Class I price? At what levels?

Base plus adjustment for current supply/demand situation

One proponent of decoupled pricing suggested setting a base price (1996 price levels have been suggested) and adjust based on the more generic "current supply/demand situation." Additionally, it was suggested that Market Administrators would be granted the authority to make adjustments through an informal rulemaking process. This proposal may have merit, however, the suggestion at this point lacks a defined price mover. Other unanswered questions include: Are 1996 price levels appropriate for a base price? Should adjustments be made on a regional level as suggested by providing authority to Market Administrators or should adjustments be made at the national level? If done on a regional basis, how does one maintain price alignment? What factors should decision makers consider in a rulemaking process?

End Product Pricing for All Classes of Milk

Some comments were written in support of end product pricing. One comment recommended end product pricing on all classes of milk. Others were unclear on whether to include all classes. As suggested, under end product pricing, milk components would be priced according to their value in the product mix.

A number of questions are latent in the underpinning of end product pricing. Mathematically it is relatively easy to take commodity prices and work backward on the average. However, where is the appropriate "end" to work backward from? Nonfat dry milk, for example, is not an end product at the consumption level. Likewise, sweet butter can be used for ice cream, etc.

Is a Class I milk value properly discovered based on component value in manufacturing products? Do make allowances protect inefficiencies in the manufacturing sector and thereby transfer costs to other sectors?

On the other hand, technology is driving the industry toward being able to fractionalize whole milk into components. These components may be reconfigured into various products. This will change the product mix and may ultimately affect the assembly and distribution costs of milk.

End product pricing is also contained within the work of the BFP committee. It is appropriate to wait for the result of their analysis.

Determine Prices Based on Cost of Production

Milk price is a result of the supply and demand conditions in the marketplace. The cost of producing milk is obviously a factor in the supply function. However, many other factors affect the price of milk. Demand influences such as household income levels, prices of substitutes or complements and availability all have a significant impact on the price. Pricing milk solely on the cost of production lacks economic justification. Since cost is a factor, it could be considered for use in an economic formula. However, additional information and analysis are needed in order for this committee and/or the BFP committee to further consider this option.

Other Comments

A number of comments recommend that the committee evaluate various components of the current price structure without providing specific proposals. Other comments advised both prudence and careful analysis based on economic factors before making changes. Many of these comments are contained within the context of the overall operation of the Federal order system. A proposal, for example, may make a specific reference to Class I price to emphasize the importance of price in the regulatory system. In general some of the

comments may fit partially into a more specific category, however, the committee feels that it is important to recognize this group separately.

Ideas Developed by the Committee

Utilization based differentials were discussed extensively during the Farm Bill debate and have been discussed by the industry for several years. The committee believes such a basis for establishing differentials should be considered since the 1996 Act specifically authorizes the Secretary to use utilization rates to establish Class I differentials. Class I differentials in each market based on utilization is perceived to be based on the marketwide utilization. A formula with this percentage as a variable could yield the desired differentials. Various equations have been devised including: a linear equation, a quadratic equation, and an exponential equation.

The advantage of such a system is that it is fairly simple to understand and explain. In addition, local supply and demand conditions are recognized and used to automatically adjust the differential. The advantage of automatically adjusting the differential becomes the largest disadvantage to this approach. Alignment issues between markets become a problem in such a system. Differentials based on utilization have merit and have been reviewed by the committee in some detail. However, much more input and analysis are needed before this approach could be recommended.

RESEARCH

Cornell University has for some time maintained a spatial model that allows insight into price structure. The committee has worked with Cornell in updating input and reviewing results of the model.

Cornell describes the model in this way:

The U.S. Dairy Sector Simulator, Version 2 (USDSS2) is a direct descendant of several previous spatial models of the dairy industry. USDSS2 has been designed to be a spatially detailed model of the U.S. dairy industry. It is formulated as a capacitated transshipment model. There are three market levels in USDSS2: farm milk supply, dairy product processing, and dairy product consumption. Five dairy product groups are distinguished at the processing and consumption levels: fluid milk products, soft dairy products, hard cheeses, butter, and dry, condensed, and evaporated milk products. USDSS2 uses a multi-component characterization of milk and dairy products (currently it uses fat and solids-not-fat) to account for the supply and use of the valuable constituents in milk. Because the various processed and consumed dairy products rarely use the components of milk in the same proportion as they are available in farm milk supplies, processing plants must "balance" the use of milk components by moving intermediate dairy products, i.e., by-products of one processing operation, from one processing operation to another for use in subsequent dairy processing.

USDSS2 simultaneously analyzes the optimal location of processing facilities and farm milk assembly movements, interplant transfers of intermediate dairy products, and dairy product distribution movements. In determining this organization, USDSS2 considers the unit costs of milk assembly and interplant transfers, the costs of dairy product processing, and the costs of dairy product distribution among over 3,000 economic units covering the 48 contiguous states. Milk supply is represented by 240 supply points. There are

234 consumption points, each consuming some amount of each of the five dairy product types noted above. There are more than 300 potential locations for the processing of each dairy product type. Given estimates of producer milk marketings, dairy product consumption, and assembly, processing, and distribution costs, USDSS2 finds the least cost organization of milk, interplant, and distribution movements as well as the efficient processing locations.

The Cornell Program on Dairy Markets and Policy has done extensive analysis of price relationships using the model. The committee has reviewed this material in both an unpublished form and the recently issued staff paper on a number of occasions and in some depth. The committee has used the model results and analysis in its conceptual form to confirm that milk has value at location and that neither current nor simulated prices radiate from a single supply area.

Cornell describes the development of optimum solutions as follows:

Finally, one of the most useful and revealing pieces of information obtained from an optimization model such as this are numbers (shadow prices) which reflect the relative value of a resource. In this case, we obtain relative values of milk and milk components at geographic locations.

Besides determining an efficient set of milk and dairy product flows and a corresponding set of efficient dairy processing locations and sizes, the mathematical model previously described can be used to answer a different, but related question about the relative value of milk at the various locations specified in the data—‘given milk assembly costs, dairy product processing and distribution costs, the costs of moving bulk cream and skim between plants, the available milk supplies and their composition, and the desired dairy product demands and their composition, what would an additional

hundred pounds of milk delivered to a processor at each location be worth?'. These values are known as 'shadow prices'. As is true of any optimization model such as this, it is possible to calculate the marginal benefit of adding additional units of some scarce resource. In this case, we can determine the marginal value of an additional one hundred pounds of milk at any given location. These marginal values, or shadow prices, reflect only the costs which are used to allocate the resources in the model. **There are no prices or costs of production in the model.** More or less, the shadow prices reflect the so-called transportation differential component of the class I differential, but do not include a constant grade A differential component. To create numbers that more closely resemble the more familiar class I differentials, we add a constant to the shadow values taken from the model. **For class I differential, the constant is chosen to result in a value at Minneapolis, MN equal to the current Upper Midwest Order differential of \$1.20.** We take the fluid milk shadow value in Minneapolis, and add whatever value is necessary to achieve \$1.20. This additional arbitrary constant is then added to every class I shadow value throughout the country. The resulting values attain levels more like current class I differentials, but maintain their absolute differences. If the class I shadow value in Miami is \$2.10 more than the class I shadow value in Minneapolis, adding the same constant to both values will result in numbers which are still different by \$2.10. For the other four types of products, we add an appropriate basic formula price (plus 30¢ for class II products) to the shadow value to achieve values which look more like class prices rather than differentials.

From the description, it must be noted that the optimization model is not intended to suggest differentials at a specific location. It does, however, provide a comparative price surface that may be used to evaluate current Federal order prices or alternate price surfaces.

Analysis of results from the model of annual data for 1993 and monthly data for May and October 1995 are presented in Cornell University, Agricultural Economics Staff Paper 96-06.⁴ The results suggest a strong relationship from the midwest along a corridor to the southeast. This comparative relationship continues eastward until it nears the northeastern Atlantic coast areas where it weakens. This may suggest that the price structure in the northeast is more dependent on supply/demand conditions within that region rather than on price levels in the midwest.

The results of the model suggest that, as the price surface is moved westward, it separates from the midwest. The price surface generated by the model suggests several points in the west where supply may be available to transport to the consumption points. The western supply/consumption relationships are not, however, as clearly defined.

CURRENT WORK

The committee has taken a deliberate, systematic approach to the assigned task. Input from industry has been a major consideration. In addition, discussion with the academic community has been very beneficial. The committee has also drawn on its own resources

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Pratt, James, Andrew Novakovic, Mark Stephenson, Phil Bishop, Eric Erba, U.S. Dairy Sector Simulator: A Spatially Disaggregated Model of the U.S. Dairy Industry, Staff Paper 96-06, Cornell University, Agricultural Economics, November, 1996.

to evaluate the pricing structure. Throughout all of this analysis, the committee has strived to stay within the parameters of the assignment.

The current Class I pricing system operates with a BFP with differentials that vary by location. Because the BFP with differentials is the system currently in place and remains a recommendation from much of industry, the committee has devoted considerable time to this approach. Two questions have guided the committee's work:

- (1) Can BFP plus differentials be successfully applied to the new mandated market structure?
- (2) Does any other approach offer a better alternative?

The committee is currently addressing question (1), while allowing question (2) to be a guide in the consideration of any alternate approach.

In essence, a classified price system takes a common product such as milk and refines its demand into separate products. Historically, milk has been differentiated based on quality (either Grade A or Grade B) and types of consumption (either fluid or nonfluid products). These may be further divided in the marketing system as we have done with demand at location vis-a-vis supply at location.

A market oriented basic price has been the vehicle used to measure supply/demand relationship in the marketplace. The BFP addresses the requirement of the 1937 Act in measuring the market.

Research is ongoing, using a model to measure elements of price performance. Results obtained from the model can be translated to supply/demand surfaces and may be fitted to the price differential concept. Analysis of this type, gives some view of alternate supply points that may prove helpful in determining price references, as well as price relationships at varying locations.

Alternate pricing approaches such as determined differentials, decoupling, end product pricing, cost of production, and others, raise many fundamental questions. For example:

1. What portion of the value of milk should be included in a Federal order pool?
Does the portion have to be consistent among the new pools to meet the adequate supply mandate of law, or can it continue to vary as it does currently?
Should the Class I price reflect this totally or is some other mechanism also useful or needed?
2. The 1985 Act expanded authority in terms of marketing service. Should the Federal order system of the future discover and pool certain marketing costs?
3. Should inter and intra market structures become a consideration in a price structure that must meet the standard of obtaining an adequate supply?

4. Should price volatility be a concern in terms of not only market supply but equitable application of prices? Is advance pricing desirable and, if so, how much advance?

BFP Plus Differentials

The committee continues to endorse the idea of keeping an open agenda for consideration of options. However, the committee is beginning the process of narrowing the focus to specific pricing plans. Conceptually, a number of items remain on the table. However, at some point, each option must be refined and tested.

The committee believes, at this time, that a system of BFP plus differentials at various locations has the most merit, based on available data. The committee has made the assumption that the replacement for the BFP will continue to be market driven. From this springboard, the range of workable differentials over large geographical areas is being suggested. (See map in Appendix D.)

The suggested Class I Differential Zones map at this time is neither market structure nor plant specific. Rather, the zone map is designed to provide broad parameters that can be used in the development of a market structure. The committee recognizes that any proposed price surface may need refinement. Further, if this concept is to be implemented, it would seem appropriate to look to the regional committees for guidance on pricing at specific locations.

The rationale for the suggested price surface is outlined briefly below.

The suggested price surface:

1. will adequately supply the market's demands, as substantiated by research from Cornell University;
2. is supported in comments filed by many in the industry; and
3. meets the guidelines given in the committee's assignment as well as the requirements established by the law.

The committee suggests that this effort be reviewed within the context it is being presented.

Is it justifiable and workable? What are its qualifications? In that regard, the committee submits that the following points should be considered:

1. The suggested price surface presents the concept of minimum prices for Class I milk at location. The model results from the work at Cornell validate that this is a sound approach to milk pricing. The application of a pricing system to individual regulated parties requires detailed and location-specific input. However, price relationship may be viewed in the corporate sense by statistical models and may be used to provide the yardstick for market demand.
2. Federal orders have as a goal an orderly marketing structure. Congress has given direction in terms of quantifying the number of markets. This option is designed to be broad enough in its final application to contribute to the pricing stability

necessary to continue an orderly system in the consolidation of the current markets.

3. The BFP plus differential system is a way to generate a pricing surface that gives market structure with minimum interference in the marketing of milk. By adopting a basic value of milk and augmenting that price level with differentials that reflect demand value for a Class I product at location, the system may operate with minimum prices and still maintain orderly marketing. In essence, it uses only minimum price as the necessary element in supplying the Class I demand.

Inherent in this approach to Class I prices is the appropriate measurement of minimum. The concept of value at location is an integral part of this suggestion from the committee. It is the position of the committee that, to maintain orderly marketing, a certain portion of Class I value must be contained within the minimum price at various locations in the system. The committee would not claim that the portion contained within the minimum price nor the portion that may be necessary to react to a local supply/demand situation is always the same among locations. It is recognized that the amount of the Class I price at a given location must be high enough to provide market stability.

- (4) The Agricultural Marketing Agreement Act requires that the Federal order system consider price as reflecting the supply/demand balance in a market. Such a standard requires that the Class I price either assure the supply or generate a structure that will assure the supply.

- (5) A Federal order is also charged with implementing a system that will allow the fluid market to be adequately supplied. This option recognizes that the demand of the fluid market is not uniformly located relative to supply points. A pricing structure, to meet this standard, must address Class I demand.

While milk value at location is the issue, Federal order price at location is a vehicle. This option, using analysis of transportation costs, develops a price surface at location of major consumption centers using Class I price differentials as a means of attracting supply to the consumption centers.

- (6) The Federal order system embraces classified pricing as an appropriate way to value the demand for fluid milk. Inherent in a classified system of value is that demand increases price above a basic product value in other uses.

This option recognizes that Class I milk has value above its value at the basic milk use level (BFP); and, that it carries a quality (Grade A) value; and, that the highest value (Class I) carries some of the supply cost to meet the higher classified value at the point of consumption.

The committee reiterates that this is a first effort and that we are open to consideration of other options. We believe, however, that the broad parameters provided in this price structure are sufficient to initiate discussion with interested parties and to provide common ground from which to compare marketing and/or pricing structures developed by members of industry, academia, government, or the public.

Impact on Small Business

It is important, at this stage of development of a pricing mechanism, to consider the regulatory impact on small business. On October 24, 1996, the Director of the Dairy Division requested the public to contribute to the analysis of the impact of regulatory changes, particularly how they may affect small business. That notice to interested parties said, in part:

We anticipate that the consolidation may have an impact on handlers and producers affected by the program. Of particular interest is the impact of these changes on small businesses. According to the Small Business Administration's definition, a dairy farm is a "small business" if it has a gross revenue of less than \$500,000 per year, and a handler is a "small business" if it has fewer than 500 employees. For the purpose of determining if a dairy farm is a "small business", the \$500,000 per year criterion was used to establish an estimated production guideline of 326,000 pounds per month for "small" dairy farmers. To clarify a handler's size, if a handler's plant is part of a larger company operating multiple plants that collectively exceed the 500 employee limit, the plant is considered a large business even if the local plant has fewer than 500 employees.

The Regulatory Flexibility Act of 1980 (RFA), as amended, specifically requires USDA to review regulations to ensure that, while accomplishing their intended purpose, they do not unduly inhibit the ability of small businesses to compete. As a result of the RFA, I am seeking your input on how small businesses may be affected by proposed changes to

Federal orders, in addition to ideas on consolidation and price structure changes. Examples of such input may include the impact of proposed regulations on a small business' ability to buy or sell milk and milk products or how proposed changes required in reporting and record keeping affect the efficiency of a small business. Input on this issue will allow USDA to use industry and public expertise to analyze the impact of regulatory changes on small businesses.

It should be noted here that this report is a "Preliminary Report". It is expected that future analysis and input will be required as the 1996 Act is implemented. The committee at this time, without excluding other concepts, has made some suggestions for a Class I pricing surface. The implementation of a minimum price system over broad geographic regions, but with some location value, will allow all segments of the industry, including small businesses, free and open access.

Price Surface Zones

The committee has developed for discussion nine broad geographic zones that cover the entire continental United States. (See Appendix D.) It is not intended that every county in the continental United States be included in Federal orders, but it is felt that the appropriate level of Class I differentials in all areas should be determined for proper alignment among areas. Suggested Class I differentials cover a range within each of the zones. Ranges of Class I differentials are provided to allow flexibility as order boundaries and specific order provisions are determined in the future.

These suggested zones are presented without a specific BFP and without market structure. The committee has assumed that the BFP will be market oriented.

Because the suggested zone lines are also drawn without market area structure, the committee is open to reviewing the zones, if requested, by the appropriate group responsible for this task.

The research conducted by Cornell University provides a framework that, as described elsewhere in this report, confirms that milk for Class I use has a different value at different locations. Using the Cornell results, together with other available resources, the committee agreed to the suggested Class I differential zones as shown on the map in Appendix D as the starting point for establishing Class I differentials across the country.

A system of minimum prices that has geographical values must reflect some relationship and this report deals with this concept using the Cornell model as a guide. The concept also involves real prices in terms of pool values. The price differentials contained within the order structure must reflect an appropriate portion of the milk's value to maintain order in the marketing system.

A classified pricing system needs to recognize both long term and short term class price relationships. The committee, at this point, with the BFP plus differential option, has to establish some reference point. If the assumption is that Class I will be priced forward, not

retroactive, then the level of the Class I price is important in distributing current month values for Class I in a pool which also includes varying portions of milk priced at the manufacturing milk value. Orderly marketing is not attained if the price formula distributes those values on a monthly basis without some recognition of the classified price concept. The signal to the supply side has to recognize the varying use, but still reflect the current demand of Class I use.

The Cornell model suggests some areas in the west as milk supply points that are independent of other parts of the milk supply. Those areas are located mostly in Federal order areas that distribute pool funds with a base Class I differential of \$1.50 to \$1.60. The committee is suggesting that any pooling structure in Zones 1, 2 and 3 may be better served by starting with a base differential of \$1.60.

Zone 1

The suggested differentials within Zone 1 would range from \$1.60 to \$1.90 per cwt. Geographically this zone is very large and encompasses the entire Northwestern United States. It consists of Washington, Oregon, Montana, Idaho, Northern and Central California, Northern and Western Nevada, Northern and Western Wyoming, and Northern Utah.

The area defined includes the top milk production state as well as two more of the top ten milk producing states. Milk production in this region has grown and continues to do so.

Milk production in this zone tends to be concentrated in three areas: Western Washington and Oregon, the Southern Valley of Idaho and Northern Utah, and the Central Valley of California. Due to the numerous mountain ranges it encompasses, much of the zone is rural and sparsely populated. The exception is the heavily populated Western Coastal areas.

Class I utilization for this zone is fairly low and a significant amount of manufacturing is required to balance the markets. Manufacturing facilities are readily accessible in the milk producing areas. Zone 1 has excess supplies of milk, and therefore, could be an additional source of milk for other regions of the country.

In the committee's view, Zone 1 will continue to maintain an adequate milk supply for the Northwestern United States. Adequate supplies of milk are within relatively short distances of plants so as to not require significant location adjustments within the zone.

Zone 2

The suggested differentials within Zone 2 would range from \$1.60 to \$2.65 per cwt. Zone 2 is a large region encompassing the Southwestern United States. It consists of Arizona, New Mexico, Colorado, Southern California, Southeastern Nevada, Southern Utah, Southeastern Wyoming, Southwestern Kansas, West Texas, and the Panhandle of Oklahoma.

The area defined includes portions of two of the top ten states in milk production as well as two more in the top twenty. Milk production in this zone has grown significantly over the last several years, but has recently slowed. Milk production in this zone tends to be concentrated in five areas: the Southern Valley of California, the Phoenix area of Arizona, North Central Colorado, the El Paso area of Texas and New Mexico and the Roswell area of New Mexico. Much of this region is rural and sparsely populated due to the mountainous and arid terrain. The only heavily populated area is the Coastal region of Southern California. For the rest of the zone, populated areas tend to congregate around the capital cities of the Southwestern states.

Class I utilization for this area is slightly greater than the average for the United States. Manufacturing is needed to balance these markets, however, only a limited number of plants are located within the zone. Milk supplies in the zone are ample for Class I demand, but not always within a short distance of these needs. Distant manufacturing facilities are used at times for balancing. Other regions of the country have relied on this zone as a supplemental supply source.

In the committee's view, adjustments are needed in the existing Class I price structure of this zone due to the changes in the supply and demand relationships. The zone has provided a source of milk for distant markets in the past, but the future is still unclear. Only a slight change in the manufacturing capacity of the zone could change milk availability for

other regions. Some location adjustments may be needed for alignment purposes with the more deficit markets to the East.

Zone 3

The suggested differentials within Zone 3 would range from \$1.60 to \$1.80 per cwt. This zone includes two of the nation's top five milk producing states, Wisconsin and Minnesota, as well the substantial milk supplies available in parts of surrounding states. The vast majority of milk in Zone 3 is used for manufacturing purposes throughout the year. In addition, as was readily apparent in the fall of 1996, this area provides large quantities of milk to distant markets at times of shortages for fluid purposes in those markets. The \$1.60 matches the Class I differential in zones to the Southwest and West that also use substantial quantities of milk for manufacturing purposes throughout the year. The 20-cent range provides some flexibility in setting Class I differentials that align with neighboring zones and in encouraging shipments to high Class I demand areas within the zone.

In addition, a Class I differential of \$1.60 to \$1.80 in this zone will provide a greater incentive for manufacturing organizations in this zone to pool milk. Historically, small pool draws (that at times fluctuate between positive and negative) and negative location adjustments have combined to create disorderly marketing conditions. Small pool draws have meant that manufacturing organizations have found it only marginally profitable to meet the shipping percentages required to pool their milk. Generally, over-order charges have been required to ensure adequate milk supplies for fluid purposes. The \$1.60 to

\$1.80 Class I differentials recommended here will help to provide more predictable pool draws, increase orderly marketing, and ensure that Federal orders in this zone provide the proper incentives for manufacturing organizations to adequately supply the fluid market.

For a number of years, prevailing over-order charges in this zone have resulted in effective Class I prices to fluid milk processors that are well above the Federal order minimums herein proposed. Thus, Class I processors should see no increase in their milk procurement costs, but would likely only see a partial redistribution of their costs from over-order charges to Federal order obligations.

Zone 4

The suggested differentials within Zone 4 would range from \$2.65 to \$3.65 per cwt. Geographically, this zone is fairly small and primarily covers two states: Louisiana, west of the Mississippi River, and central and east Texas.

The zone defined has a significant amount of milk production and population. Texas ranks as the sixth largest milk producing state and is the second most populated. Milk production in this zone is concentrated in two areas: East of Dallas and Southwest of Dallas. Population centers are spread throughout the region with significant population along the Gulf Coast of Texas and Louisiana.

Class I utilization is moderately high and the zone has primarily been considered a fluid market. Much of the manufacturing in this zone is based on weekly and seasonal balancing. Excesses tend to be limited to Spring flush periods while Fall usually brings a deficit. Local demand along the Southern Coastal area requires supplies to travel significant distances to meet fluid demands. Seasonal deficits are handled by various other regions of the country.

In the committee's view, the differential range proposed is needed to move milk supplies south and east to align with Southeastern deficit markets. Zone 4 may depend increasingly on milk suppliers from other regions of the country. However, the range of differentials suggested should be adequate to maintain a local milk supply.

Zone 5

The suggested differentials within Zone 5 would range from \$2.00 to \$3.00 per cwt. Geographically this zone ranges from Maine in the east to Oklahoma and southeastern Kansas in the west. The zone encompasses a part of the many milk producing areas of New York and Pennsylvania and the more dispersed production in the eastern mountains; the Ohio and mid-Mississippi River basins and reaches into the southwestern United States. This zone is populated with a mix of rural areas plus a number of medium sized metropolitan areas. The suggested price flow is generally from north to south and from west to east within this long narrow zone. It is expected that, when markets are structured, some recognition of the \$2.00 differential is necessary as it aligns with a similar differential in Zone 8. The \$3.00 differential would similarly align with Zone 6, Zone 9 and the eastern portion of Zone 4. While it is necessary to retain some flexibility within the zones, this pricing surface is supported generally by the Cornell model.

The pooling of milk value represented by a market oriented BFP plus Class I differential in the listed range will provide, in the committee's view, a structure to adequately supply the zone's needs for milk.

Zone 6

The suggested differentials within Zone 6 would range from \$3.00 to \$3.75 per hundredweight. Geographically this zone encompasses all of South Carolina, most of the

states of North Carolina, Georgia, Alabama, Mississippi, and some parts of Louisiana and Florida.

The progression of the differentials would be generally toward the southeast. It is expected that, when markets are structured, some recognition of the \$3.00 differential is necessary as it aligns with a similar differential in Zone 5. Higher differentials within the zone would then be anticipated as the surface moves south to Zone 7 and south and west to the eastern end of Zone 4. The Atlantic and Gulf Coast areas of this zone would also be in consideration for the higher end of the suggested range. The coastal regions are not heavy milk production areas, and with price as the signal, a higher differential would be appropriate to adequately supply the markets.

This is a zone of deficient and declining milk production. This zone contains many rural areas with heavy concentration of population along a corridor from Raleigh, North Carolina, to Atlanta, Georgia. It is a zone which currently has a high Class I utilization and little access to manufacturing milk facilities.

Zone 6 may depend increasingly on milk supplies from outside the area. In the committee's view, the pooling of milk values represented by the suggested differentials, with an appropriate market oriented BFP will be adequate to maintain milk supply.

Zone 7

The suggested differentials within Zone 7 range from \$3.75 to \$4.30 per cwt. Geographically it encompasses all of the lower two-thirds of Florida. Annual milk production in the zone does not meet Class I needs. Milk supplies needed to serve demand in this zone are procured from distant areas of the country. It is anticipated that the price would increase as the surface moves from north to south allowing milk to move to more deficient areas of Florida. Population density relative to viable milk producing areas within this zone is creating increasing land use pressure. The pooling of milk at the suggested differentials for Class I using a market oriented BFP will, in the committee's view, be adequate to attract necessary milk supplies.

Zone 8

The suggested differentials within Zone 8 range from \$1.80 to \$2.00. The zone covers parts of 12 states ranging from the southwest corner of South Dakota to the western corner of New York. This zone, together with parts of Zone 5, form an intermediate area between Zone 3, where milk is used primarily for manufacturing purposes, and Zones 4, 6, 7 and 9 where milk is used primarily for Class I purposes. The price range in this zone would provide for alignment with markets to the north, south and east, and set differentials at a level that would recognize the supply/demand conditions in this area. Alignment of Zone 8 with neighboring zones, particularly to the east and south, would minimize disruption to current competitive relationships for Class I handlers in these areas.

Zone 9

The suggested differentials within Zone 9 range from \$3.00 to \$3.35 per cwt. Geographically Zone 9 encompasses the north Atlantic coastal area of the United States. The zone includes the major cities of Boston, New York, Philadelphia, Baltimore and Washington, DC. The differentials in Zone 9 allow for some recognition of the need to move milk to major metropolitan areas on the Atlantic coast. The 35-cent range will provide the pool structure to compensate for an individual location within a narrow geographic area.

Zone 9 represents a major consumption area. The zone will need to look to the milk production areas north and west of the cities for milk supply. In the committee's view, the pooling of milk values represented by the suggested differentials with an appropriate market oriented BFP will be adequate to maintain milk supplies.

ORDER LANGUAGE

The development of Federal order language is relatively simple with the BFP plus differential concept using these nine Zones as guidelines. Since the committee has only addressed price relationship and not yet recommended any timing of price application, the following framework of order language is appropriate:

Class I Price. The Class I price shall be the basic formula

price for _____ plus \$____.

FUTURE CONSIDERATIONS

Since the time line available to interested parties has not yet reached its end, the committee will continue to review and analyze alternatives. Many of the industry suggestions were submitted as concepts, and in some instances indications are that further development would be supplied.

In addition, the work of the BFP Committee has not been completed. The Price Structure Committee has been working on the assumption that a BFP would remain market oriented. The committee has put forth suggestions without defined marketing areas, pooling requirements, marketing service payments, and pooling costs, etc.

Based on public input through late October, 1996, and the available data, the Price Structure Committee believes the idea/concept(s) suggested in this report have merit at this time. The committee and Department are open to continuous public input and may make revisions to this report as additional information becomes available.

APPENDIX A

May 2, 1996

TO: Interested Parties

FROM: Richard M. McKee /s/
Director
Dairy Division

SUBJECT: Announcement of Procedures to Implement the 1996 Federal Agricultural Improvement and Reform (FAIR) Act Mandates to the Federal Milk Order Program

The 1996 FAIR Act signed by President Clinton on April 4, 1996, requires that the current 33 Federal milk marketing areas be consolidated, or merged, into 10 to 14 orders within 3 years. This is an enormous undertaking that will require the cooperation and support of the industry. Also, the Secretary is directed to designate the State of California as a Federal milk order if California dairy producers petition for and approve such an order. Finally, the FAIR Act specifies that the Department (USDA) use informal rulemaking to implement these reforms.

The authorization of informal rulemaking to achieve these reforms will result in a rulemaking process that is substantially different from the formal rulemaking process that has always been used to promulgate or amend Federal orders. The formal rulemaking process requires that decisions be based solely on the evidentiary record of a public hearing held before an Administrative Law Judge. Formal rulemaking involves the presentation of sworn testimony, cross-examination of witnesses, opportunity to file briefs, issuance of a recommended decision, the filing of exceptions, and the issuance of a final decision voted on by affected producers. The informal rulemaking process does not involve these procedures. Instead, informal rulemaking provides for the issuance of a proposed rule by the Agricultural Marketing Service, a period of time for the filing of comments by interested parties, and the issuance of a final rule by the Secretary. Typically, informal rules do not require a referendum to determine approval; however, this proceeding will require a referendum to determine producer approval of the new orders.

Although not required, USDA will not issue a proposed rule of this magnitude without full participation of interested parties. The issues are too important and complex for a proposed rule to be developed without significant input from all facets of the dairy industry. We believe that the experience, knowledge and expertise of the industry are essential to the development of a proposed rule. Thus, USDA has developed a plan of action and time line that will allow for maximum industry input into the process while still meeting the legislated deadline of April 4, 1999. The process will consist of two phases. The first phase is a developmental process and the second phase is the rulemaking process. The use of a developmental phase will allow USDA to interact freely with the industry to develop a viable proposal to accomplish the mandates and is crucial to gaining maximum industry input in the process. During the developmental phase, USDA is not subject to ex parte rules specified in the Sunshine Act (Pub. L. 94-409). The developmental phase began on April 4, 1996, and will continue through late 1997 when the proposed rule is published in the Federal Register.

As the first stage in the developmental phase, USDA is requesting that all interested parties submit ideas on the reforms set forth by the FAIR Act. Of primary importance at this time is the consolidation of the 33 Federal orders and how the pricing structure may be revamped. All ideas submitted should include an explanation and a justification statement. Market Administrators are available to provide assistance and/or data in the development of ideas. These ideas should be sent to me at the following address: Richard M. McKee, Director, Dairy Division, USDA/AMS, Room 2968, South Building, P.O. Box 96456, Washington, D.C. 20090-6456. Ideas will be received throughout the entire process; however, submissions by July 1, 1996, would be appreciated.

Continuing the developmental phase, in late fall, USDA will issue an announcement outlining preliminary marketing areas and a possible pricing structure. Following this issuance, informal discussion sessions will be held with interested parties to obtain input on the preliminary report. We anticipate these meetings to be organized by the Market Administrators as requested. Written suggestions will also be requested on the preliminary report.

The next step in the developmental phase will occur in late spring 1997 when USDA expects to issue a revised report on the marketing areas and pricing structure. This report will also include concepts and ideas for other order provisions. Again, informal discussion sessions will be held with interested parties to obtain input on the report and written suggestions will be requested. It is the goal of USDA that through this developmental process a proposed rule can be developed that will address the mandates specified in the Farm Bill and other reforms consistent with the Administration's goals.

The rulemaking phase will begin once the proposed rule is published in the Federal Register in late 1997. Interested parties will be provided 60 days to file written comments with USDA. After reviewing these comments, USDA will publish a final rule in the late summer of 1998. Informational meetings will be held with interested parties to explain how the new orders will be implemented and the projected effect on producers and handlers in each new marketing area. Producers will vote in a referendum on the new orders. Upon approval, USDA anticipates issuing a final order making the new orders effective on January 1, 1999.

Attached is a projected time line for this process.

The legislation requires substantial reform of the Federal order program. USDA is committed to utilizing the expertise in the industry to the fullest extent in developing a proposed rule. We welcome your ideas and contributions in meeting the mandates of the 1996 FAIR Act. If you have any questions concerning this process, please contact my staff or me at (202) 720-4392.

Attachment

Below is a projected time line for implementing the Farm Bill Federal milk marketing order reforms within the statutory deadline.

Program Announcement to interested parties advising of FAIR Act requirements and procedure to be followed.	Late Spring 1996
Announce preliminary mergers and pricing structure in an announcement to interested parties.	Late Fall 1996
Hold informal discussion sessions with the public to further develop preliminary mergers and pricing structure as requested.	Winter 1996-97
Announce revised marketing areas, pricing structure and concepts for specific order provisions.	Late Spring 1997
Hold informal discussion sessions with the public to further develop order provisions as requested.	Late Spring 1997
Issue proposed rule in <u>Federal Register</u> . Interested parties will be provided 60 days to submit written comments.	Winter 1997
Issue final rule in <u>Federal Register</u> .	Summer 1998
Conduct informational meetings with interested parties about the new orders.	Summer 1998
Conduct referendum to determine producer approval.	Fall 1998
Publish final order in <u>Federal Register</u> .	Fall 1998
New orders effective.	January 1, 1999

APPENDIX B

Appendix B - Milk Production and Population Regions

This version of the report is text only. Click [Appendix B](#) to view/print this graphic.

APPENDIX C

Public Input through FOR 127

Current System BFP (market driven) plus price differentials

FOR

- 5 Gene Hugoson for Minnesota Department of Agriculture-Recommends flattening or eliminating the Class I minimum pricing differential.
- 8 Dr. Kenneth W. Bailey, University of Missouri-Suggests moving away from the concept of one national market for manufacturing milk as expressed by the BFP and adopting a system of regional cash auction markets. The regional auction markets would effectively create multiple basing points for Grade A milk used for manufacturing. Classified pricing would still function as in the past, however, Class I prices would no longer be lagged by two months. Class I and II prices would be based on current Class III prices (not lagged since this distorts price signals to dairy farmers) plus new class price differentials conditioned on the new multiple basing points.
- 12 James Moore for Holland Dairies, Holland, IN-Proposes to consolidate Federal Orders 32, 46, 11, and parts of Orders 33, 49, and 7 in order to eliminate and correct the unfair advantage of a \$.19 Class I differential advantage over Order 46 processors presently enjoyed by a competitor in Order 32.
- 13 Jack Kidwell for Florida Dairy Farmers Association-Suggests as part of a three Florida market merger, increase Class I differentials in Miami by 10 cents to \$4.28 and in Tampa Bay by 5 cents to \$3.93 while keeping alignment with current differentials in Jacksonville/Tallahassee (\$3.58) and Atlanta (\$3.08).
- 16 Sydney Berde, St. Paul, MN for a group of Midwest, Southern and Southwest Coops. FAIR Act does not require substantial change in Class I differentials. Current Class I differential system could be continued if based on current economic and marketing data (but not to be based on 1985 Farm Bill differentials). Suggests caution in implementing large changes to the current Class I differential system. Does not provide a specific proposal for what the Class I prices should be.
- 19 Cebulla (North American State Bank), Belgrade, MN, ag banker
Complains that Class I differentials treat Minnesota and Upper Midwest unfairly. Proposes legislation to “level the playing field for all dairy farmers.” Refers in general terms to flattening out Class I differentials.
- 34 Tommy Rucks for Florida Dairy Farmer's Association-Proposes merger of three Florida Orders and specifies location adjustments.
- 35 Charles M. English for Tillamook County Creamery Association-Suggests reevaluating Class I differentials and set upper limit at the value of reconstituted concentrated milk. Also proposes uniform MCP when markets are less than 50% Class I utilization.
- 36 Charles M. English for Southern Food Group & Anderson-Erickson-Suggests reevaluating Class I differentials and set upper limit at the value of reconstituted concentrated milk. Also suggests that part of the Class I differential to assure delivery to fluid plants and that Class I should be linked to manufactured milk and not fixed over several months.

- 37 Donald Glam, Minnesota Dairy Farmer-Suggests a "level playing field" versus distance from Eau Claire.
- 40 Andy Vander Meulen for Northwest Ind. Milk Prod. Assn, Mt. Vernon, WA-Suggests setting BFP off some formula with a reliable national and/or regional feed index mover. Class I and II differentials could be determined as presently being done. Also proposes Class IIIa and IIIb based on product price formulas.
- 42 Don Ommodt for Cass-Clay Creamery, Fargo, ND-Suggests basing points in Idaho and California with progressively higher prices moving east, highest prices in Florida.
- 45, Doug Marshall for Darigold, -Supports continuing a Class I differential (or price surface),
86 however, the BFP should not necessarily be equal to the Class III price. Stabilize BFP by announcing for a 2 or 3 month period.
- 48 E. Linwood Tipton for International Dairy Foods Association-Makes two suggestions; **1-Maintain current classified pricing structure with 2 classes (Class I-fluid; Class II other products), BFP would reflect value of milk used for mfg in the Western states;** 2-eliminate all mfg milk classes and pool only Class I differentials.
- 52 Jim Box for AMPI-Southern Region-Recommends that Class I differentials in the Southwest should remain the same. Suggests that Roswell, NM is acceptable as a basing point.
- 53 Dormal Newberry for Barber Pure Milk Company, Birmingham, AL and Dairy Fresh Corporation, Greensboro, AL-Supports current system with quarterly (or longer period) pricing periods.
- 54 John Umhoefer for Wisconsin Cheese Maker's Association-Suggests keeping BFP plus differentials, but flatten differentials.
- 55 Bob Lake for Borden/MeadowGold Dairies, Ogden, UT-Proposes lowering the Class I differential in Eastern Colorado from \$2.73 to \$2.05.
- 58 James Kalkofen for Lakeshore Federated Dairy Coop, Rockford, IL-**Proposes consolidation of Upper Midwest orders, raising minimum Class I differentials and also minimizing differences in Class I prices.** Alternative proposal-two part Class I differential; 1st part a uniform Class I differential; 2nd part-supplemental Class I differential to cover assembly credits, transportation credits and balancing.
- 84 Jay F. Gould, Western United Dairymen-**Opposes lower Class I differentials.** Possible move toward end product pricing (uncertain if they want this on all milk).
- 91 Harold Schild for Tillamook County Creamery Association-**Suggests the Class I differential should be established by region, based on the BFP,** adjusted quarterly, and pooled among dairymen in their respective Federal Orders.
- 100 Robert J. Williams for TAPP-Proposes a flat differential of \$2.00 in a consolidated upper Midwest. Eau Claire, WI and Albuquerque, NM as basing points. Increase Class I price towards East and Southeast by the cost of transporting powder. Florida differential would be approximately \$4.13.
- 112 Gene Koopman for Milk Producers Council, CA-Supports raising low end Class I differentials. Suggests regional minimum prices for milk used in manufacturing.

- 117 John Vetne for Shamrock Foods Company-Suggests Class I prices in the Central Arizona order are higher than adjoining state or federally-regulated areas. Supports the lowering of the Central Arizona differential from \$2.52 to \$1.60. Alleges current supply/demand conditions no longer warrant a higher price as Arizona's production has increased 66% since 1985 and Class I utilization during 1995 was 48%.
- 120 Sydney Berde for United Dairymen of Arizona-Opposes lowering the Central Arizona differential to \$1.60. Disputes arguments presented by Shamrock Foods and argues for retention of the \$2.52 differential. Cites that although the production has increased by 66% since 1985, the population has increased 40%, excluding increased tourism.

Alternate Approaches

A. Announce Class I Prices for a Longer Period

FOR

- 9 Paul Christ for Land O Lakes, Arden Hills, MN-Recommends adopting a two-tiered Class I differential; 1st tier uniform flat differential of \$1.00; 2nd tier-additional Class I differential set annually by the Market Administrator to cover cost of transportation credits and balancing payments. Also, proposes a **quarterly BFP for Class I** calculated from the futures market and a monthly BFP for Class III calculated from the futures market.
- 38 Bruce BeVier for Melody Farms, Livonia, MI-Suggests quarterly pricing for all classes and "reasonable" Class I differentials.
- 45, Doug Marshall for Darigold-Supports continuing a Class I differential (or price surface),
86 however, the BFP should not necessarily be equal to the Class III price. **Stabilize BFP by announcing for a 2 or 3 month period.**
- 51 Ronnie Anderson for Louisiana Farm Bureau Federation-**Proposes announcing Class I prices quarterly or using a 12 month moving average of the BFP.** Also, proposes careful consideration of impact before establishing multiple basing points.
- 53 Dormal Newberry for Barber Pure Milk Company, Birmingham, AL and Dairy Fresh Corporation, Greensboro, AL-Supports current system **with quarterly (or longer period) pricing periods.**
- 79 Ed Joiner for Louisiana Farm Bureau-Proposes "decoupling" of Class I prices from the BFP "because the two month lag between the BFP & Class I price doesn't properly reflect Class I market needs and it would increase stability of fluid milk prices." Alternatives include a formula price such as the California Class I price, **limiting price changes to quarterly price adjustments**, an economic formula including the BFP, **seasonally adjusted price tied to a 12 month BFP average.**
- 91 Harold Schild for Tillamook County Creamery Association-Suggests the Class I differential should be established by region, based on the BFP, **adjusted quarterly**, and pooled among dairymen in their respective Federal Orders.
- 114 Wayne Dollar, President Georgia Farm Bureau Federation-Suggests the pricing system in the orders should encourage movement of Class I milk to the deficit SE area and that differentials should reflect 70-75% of the cost of moving milk from surplus production areas. This would be sufficient to encourage the movement of milk without encouraging an oversupply in the SE region. Supports the decoupling of Class I price from the current basic formula price. Suggests alternatives of a formula price, such as the California Class I price, **limiting price changes to quarterly Class I adjustments, or a price tied to a long-range moving average of the BFP.**
- 123 William Moore for Georgia Milk Producers-Suggests that differentials should reflect 70-75% of the cost of moving milk from surplus production areas. Implies that this would be sufficient to encourage the movement of milk without encouraging an oversupply in the SE region. Suggests

that Florida cooperatives proposed pricing zones should extend north into the SE. Recommends that with plant reductions, some SE zones should be widened and moved north. Additionally, suggests a seasonal snubber to increase the Class I price when utilization is above the long term average for an order should be implemented. Supports the decoupling of Class I price from the current basic formula price. Suggests alternatives of a formula price, such as the California Class I price, **limiting price changes to quarterly Class I adjustments, or a price tied to a long-range moving average of the BFP.**

B. Two-Tiered Class I Differential

FOR

- 9 Paul Christ for Land O Lakes, Arden Hills, MN-**Recommends adopting a two-tiered Class I differential; 1st tier uniform flat differential of \$1.00; 2nd tier-additional Class I differential set annually by the Market Administrator to cover cost of transportation credits and balancing payments.** Also, proposes a quarterly BFP for Class I calculated from the futures market and a monthly BFP for Class III calculated from the futures market.
- 58 James Kalkofen for Lakeshore Federated Dairy Coop, Rockford, IL-Proposes raising current Class I differentials in Upper Midwest. **Alternative proposal-two part Class I differential; 1st part a uniform Class I differential; 2nd part-supplemental Class I differential to cover assembly credits, transportation credits and balancing.**
- 61 Will Hughes for Upper Midwest Dairy Coalition-Suggests a two part Class I differential; 1st part uniform flat differential to encourage grade A production; 2nd part vary across markets and based on balancing, assembly and transportation services. Also proposes a Grade A/B based BFP.
- 99 Lavern Neisuis, Clark County Wisconsin Farmers Union-Supports FOR 61.

C. Pooling Class I Differentials Only

FOR

- 46 Audrey F. Throne for Hershey Chocolate North America, Hershey, PA-Proposes to eliminate all manufacturing milk classes and pool only Class I differentials.
- 48 E. Linwood Tipton for International Dairy Foods Association-Makes two suggestions; 1-Maintain current classified pricing structure with 2 classes (Class I-fluid; Class II other products), BFP would reflect value of milk used for mfg in the Western states; **2-eliminate all mfg milk classes and pool only Class I differentials.**
- 74 Mary Keough Ledman for National Cheese Institute-Proposes pooling Class I differentials only.
- 75 Gary Corbett for Milk Industry Foundation & International Ice Cream Association-Proposes pooling Class I differentials only.

D. Total Decoupling of Class I from BFP

FOR

- 78 Robert Wellington, Agri-Mark, Methuen, MA-Supports using California system (audited end product pricing information for mfg products and "decoupled" Class I prices).
- 83 James Tillison, The Alliance of Western Milk Producers-Supports multiple basing points with Class I price being a formula price adjusted for changes in dairy commodity values (California System).
- 111 John Wilson for Mid American Dairymen, Springfield, MO-Proposes "decoupling" Class I and II prices from Class III and IV prices. Fix Class I prices at 1996 levels and adjust according to the supply/demand situation in the local market. Adjustments would be made through an informal rulemaking process based on industry comments to Market Administrators.
- 114 Wayne Dollar, President Georgia Farm Bureau Federation-Suggests the pricing system in the orders should encourage movement of Class I milk to the deficit SE area and that differentials should reflect 70-75% of the cost of moving milk from surplus production areas. This would be sufficient to encourage the movement of milk without encouraging an oversupply in the SE region. **Supports the decoupling of Class I price from the current basic formula price. Suggests alternatives of a formula price, such as the California Class I price,** limiting price changes to quarterly Class I adjustments, or a price tied to a long-range moving average of the BFP.
- 121 Rodney Carlson for Milk Marketing Inc-Suggests milk price must increase as we move South and East to move milk from areas of surplus production. Recommends that a price surface should be established that avoids encouraging uneconomic milk movements and sends the proper economic signals to farmers and the industry. Also suggests prices need to reflect current marketing conditions more quickly and could be accomplished by identifying regional supply/demand conditions that could be used to establish Class I and Class II prices. Additionally, suggests that all Class I and Class II prices do not have to move at the same time nor by the same amount. **Recommends decoupling Class I and Class II from the basic formula price.**
- 123 William Moore for Georgia Milk Producers-Suggests that differentials should reflect 70-75% of the cost of moving milk from surplus production areas. Implies that this would be sufficient to encourage the movement of milk without encouraging an oversupply in the SE region. Suggests that Florida cooperatives proposed pricing zones should extend north into the SE. Recommends that with plant reductions, some SE zones should be widened and moved north. Additionally, suggests a seasonal snubber to increase the Class I price when utilization is above the long term average for an order should be implemented. **Supports the decoupling of Class I price from the current basic formula price. Suggests alternatives of a formula price, such as the California Class I price,** limiting price changes to quarterly Class I adjustments, or a price tied to a long-range moving average of the BFP.

E. End Product Pricing for All Classes of Milk

FOR

- 4 Calvin Covington and Michael Brown for National All-Jersey, Reynoldsburg, OH-Recommends consideration of end product pricing for all classes of milk. Class I prices would be determined based on skim and butterfat values plus Class I differentials for each order.
- 84 Jay F. Gould, Western United Dairymen-Opposes lower Class I differentials. **Possible move toward end product pricing (uncertain if they want this on all milk).**

F. Determine prices based on cost of production

FOR

- 56 J.H. Mayes for Mayes Farm et al, Pulaski, TN-Proposes to combine Class I and Class II and base price on "USDA regional cost of production using full absorption costing principles plus \$1.00 for profit." Class III and III-A should be Class I - \$2.00. Prices should be adjusted annually for feed costs.

G. Others

FOR

- 11 Dean Kleckner for American Farm Bureau Federation-Suggests that classification differentials should be evaluated, including consideration for "decoupling" prices for fluid milk and soft products from the Class III price. The writer does not explain decoupling.
- 17 Feingold, et al., U.S. Senator Feingold and nine other Senators from the Midwest Suggests that Class I prices should not be based on distance from one point. Proposes reducing Class I differentials that were "artificially inflated" in the 1985 Farm Bill. Transportation costs from a base point should not be the only criteria for setting Class I prices. Multiple basing points should be considered for Class I pricing.
- 47 Jonathan Tolman for The Competitive Enterprise Institute-Proposes general deregulation.
- 59 Phil English, US House of Representatives, PA-Supports a price structure that reflects the additional costs associated with producing milk for the fluid market. Long and short term impacts on dairy farmers must be evaluated before there is any radical change in price structure.
- 110 Gerald Solomon, US House of Representatives, New York-Suggests that economic factors should guide the process of establishing Class I differentials.
- 119 Bud Cramer, US House of Representatives, Alabama-Suggests the price structure reflects the fact that there are additional costs associated with producing milk for the fluid market and this should continue. Any radical change in the differential price structure without evaluating long and short term impacts on dairy farmers could cause severe economic hardships.

APPENDIX D

Appendix D - Suggested Class I Differential Zones

This version of the report is text only. Click [Appendix D](#) to view/print this graphic.